Impediments to Growth of the Garment and Food Industries in Cambodia: Exploring Potential Benefits of the ASEAN–People's Republic of China Free Trade Agreement

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Abstract

This paper attempts to identify structural constraints to growth and exports within Cambodia's key industries and to consider the policy actions needed to reduce obstacles to trade. The paper places special emphasis on Cambodia's exports to the People's Republic of China (PRC), given the major export opportunities arising from the free trade agreement between the Association of Southeast Asian Nations (ASEAN) and the PRC, known as the ASEAN–PRC Free Trade Agreement (ACFTA). A qualitative case study method was applied at the firm level by conducting face-to-face interviews to identify the impediments to the growth and exports of key industries in Cambodia, and to examine the opportunities and challenges presented by the ACFTA. This study covers the garment and food industries, which are critical to the economic development of Cambodia in the context of regional and global economic integration. The food industry, with its large number of small and medium-sized enterprises, has great potential to contribute to pro-poor growth in Cambodia, while the textile industry is the largest employer in the Cambodian labor force and is critical for poverty reduction efforts through export-led growth. The study also provides policy recommendations at both the industry and government levels.

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Introduction

Exports are a driving force for economic development in many emerging economies. This is especially true for transitional economies in Southeast Asia, such as Cambodia, that are in the midst of rapid regional and global economic integration. The recent phenomenon of signing free trade agreements (FTAs) brings both considerable opportunities and challenges to the industries of the contracting parties. In particular, the FTA between the Association of Southeast Asian Nations (ASEAN) and the People's Republic of China (PRC), known as the ASEAN–PRC Free Trade Agreement (ACFTA), has attracted considerable attention from policy makers and researchers because of its potential impact on the region's economies.

However, transitional economies in Southeast Asia may not be able to easily exploit the benefits of FTAs such as ACFTA. Given that industries in these countries are vulnerable to external shocks, a close examination of the potential positive and negative impacts of the ACFTA is critical in designing relevant trade adjustment policies. In addition to the difficulty of taking advantage of preferential access to partner economies under an FTA, traders in ASEAN's poorer members face more fundamental impediments, such as burdensome paperwork and under-the-table fees. Thus, it is important to address both the general issues of trade impediments and the obstacles that prevent traders from maximizing the benefits of FTAs, and to consider the necessary policy actions. This paper assesses the impediments to exports in the case of Cambodia, with special reference to the impacts of the ACFTA[1] on key industries in the country.

There are various complementary methods that can be used to assess the effects of FTAs. While the gravity model is a popular ex-post method, the results should be carefully read if it is to be used to analyze the impact of the ACFTA, particularly on Cambodia.[2] Any macro-level model exercise should be accompanied by micro-level analysis to infer clear policy implications. Meanwhile, the majority of existing firm-level surveys that assess the impact of FTAs in Asia tend to focus mostly on incumbent exporting firms in major Asian countries, usually not including Cambodia. While the conduct of large-scale firm-level surveys in Cambodia should be encouraged, a methodological problem of the firm-level survey is persistent, especially when analyzing less developed countries such as Cambodia. Random sampling or even complete enumeration (census) surveys of exporting firms do not produce plausible policy implications for countries' export strategies because potential users of FTAs are nonexporters at this stage. Furthermore, information on the use or nonuse of FTAs is not the only type of information that is valuable; detailed anecdotal information on the impediments to trade in the general sense, as well as on specific obstacles to the use of the ACFTA, should be collected through interviews.

This paper employs a qualitative case study method based on semi-structured interviews with corporate executives in Cambodia. Such a method is particularly useful for examining opportunities and challenges of FTAs in developing countries such as Cambodia, which lacks

[1] In addition to the ACFTA, Cambodia, as an ASEAN member, participates in trade agreements with Japan and the Republic of Korea. However, given the rapid increase in trade with the PRC, this study focuses exclusively on impacts of the ACFTA. According to the United Nations Comtrade Database (UN Comtrade), Cambodia's exports to the PRC increased by 154% from $36.6 million in 2009 to $93.6 million in 2010, while Cambodia's exports to Japan increased by 46% from $142.6 million in 2009 to $207.8 million in 2010. Cambodia's trade with the Republic of Korea in 2010 had not been reported by UN Comtrade as of 12 July 2011.

[2] First, the ACFTA is a fairly recent phenomenon and available data series since its implementation are very limited. Second, the accuracy of macroeconomic data from less developed countries, such as Cambodia, are questionable.

quality economic data.[3] Because it provides the micro-foundation of the overall assessment of FTA impacts, the case study approach complements other methodologies including the gravity model and firm-level survey mentioned earlier. If used properly, the case study approach is useful for extracting information to draw up the necessary adjustment policies.[4] An interview-based case study method is helpful in identifying what the real bottlenecks to exports are, what type of assistance should be offered by the government to firms to increase exports, why firms do not export despite FTA preferences, and what kinds of policy reforms are necessary to exploit the export opportunities under FTAs. Based on the responses of several interviewees, specific industry problems with regard to trade under FTAs can be identified, thereby avoiding oversimplification. This paper not only analyzes the trade policy of each company surveyed, but also attempts to clarify the difficulties faced by each industry as a whole in the context of the ACFTA.

Semi-structured interviews were conducted in the Khmer language with several firms in Cambodia in May–July 2010.[5] The firms to interview were selected carefully, considering several factors including (i) balance across subsectors, (ii) size of firms, and (iii) firms' trade volume. In most cases, a questionnaire focusing on exports to the PRC was sent to interviewees beforehand in both English and Khmer (see Annex for the questionnaire in English). Both the questions identifying the general impediments to Cambodia's trade and the questions relating to the use of the ACFTA were included in the questionnaire. Rather than testing a specific hypothesis in a purely social scientific manner, the objective was to gather as much relevant information as possible and to construct anecdotal case studies. Face-to-face interviews were then conducted with additional questions based on the responses to the questionnaire. These were followed up by telephone-based interviews when necessary.

This paper analyzes two major industries in Cambodia: the garment industry and the food industry. These industries were selected because both are vital to Cambodia in terms of production, employment, and exports, and because they have several contrasting features. The garment industry is the largest industry in terms of output and exports. The majority of firms in this industry are relatively large and have strong export orientation, and most of them have foreign equity participation. In contrast, the food industry is a typical example of a domestic industry in Cambodia with significant economic potential. Most firms in the food industry are small and medium-sized enterprises (SMEs), and further development of the industry is crucial for poverty reduction.

The next section covers the garment industry and the subsequent section focuses on the food industry. Each section starts with a brief introduction of the industry and moves on to individual companies' export policies in the context of the ACFTA. Each section concludes with a summary of empirical findings on the industries' problems in terms of trade. After the examination of the two industries, the final section of the paper considers policy recommendations to maximize the benefits and minimize the costs of the ACFTA.

[3] On the quality of Cambodia's trade statistics, see Hamanaka (2011).

[4] For example, there is an incentive to exaggerate the negative side of FTAs in the expectation of government assistance. This problem can be minimized if an interviewer poses relevant follow-up questions.

[5] Not all of the interview summaries of the selected firms are included in this paper.

Garment Industry

The garment industry is the largest industry in Cambodia, accounting for approximately 20% of all Cambodian production, 14% of gross domestic product (GDP), and 72% of total merchandise exports. It employs 320,734 workers, among which 293,664 are women, working in 269 factories across the country.[6] The garment industry is the main income generator within the Cambodian labor force. It is also the country's largest foreign currency earner and contributes about 80% of Cambodia's foreign exchange earnings every year.[7]

The Cambodian garment industry began to develop in earnest in the 1990s, with a strong orientation toward exports. The industry's production has since reached a level equivalent to 500% of that required for self-sufficiency. The main markets, in order of export value for Cambodian textiles are the United States (US), the European Union (EU), Canada, and Japan.[8] This industry is dominated by large, foreign-owned firms. In 2009, the total number of large factories in Cambodia registered with the Ministry of Industry, Mines, and Energy reached 556, of which 422 were garment-related.[9] According to the Garment Manufacturers Association in Cambodia, there are currently 136 export-oriented garment factories in Cambodia, of which 93% are foreign-owned. Most foreign direct investment in Cambodia—mainly from the PRC and Taipei,China—goes to this industry.

The garment industry emerged in response to the trade privileges established under the Generalized System of Preferences (GSP) in 1996 by the EU and the US. In 1998, the Clinton administration initiated the US–Cambodian Trade Agreement on Textiles and Apparel (1999–2004), which linked market access (with an increasing quota) for Cambodian textile products to labor standards. Cambodia is the only country with which a trade–labor arrangement was agreed and implemented in order to secure a quota for exports to the US (Ear 2009: 7). In 1999, the US imposed new quotas on all textile exporting countries except Cambodia. Meanwhile, the textile agreement between Cambodia and the EU entered into force on 1 July of the same year. This agreement formalized the principle of unlimited access of Cambodian textile products to the EU market. The privilege of unlimited access was supplemented by a liberalization of the conditions of access to the EU's GSP scheme, which grants an exemption from customs duties to Cambodian exports entering the EU market. The first measure of liberalization under the agreement included the indefinite granting to Cambodia in September 1999 of the benefit of "regional accumulation." With this privilege, unfinished textile products imported by Cambodia from another member of ASEAN and then exported to the EU are considered to be of Cambodian origin, allowing Cambodia to more easily satisfy the GSP rules of origin.

In the mid-1990s, many firms began moving to Cambodia from the PRC; Indonesia; the Republic of Korea; Taipei,China; and Thailand for three primary reasons. First, wages in Cambodia were relatively low compared with its competitors. Second, PRC companies in particular moved their factories to Cambodia to gain preferential access to European and

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6 See *People's Daily Online* at http://english.people.com.cn/90001/90777/90851/6990883.html (accessed 20 May 2010).

7 See *Business in Asia*. Update on Cambodian Garment and Textile Industry. http://www.business-in-asia.com/industries/cambodia_garment.html (accessed 20 May 2010).

8 In 2009, total garment exports to foreign countries amounted to $2,385 million, of which $1,486 million was exported to the US, $577 million went to European markets, $184 million went to Canada, and $136 million went to other countries.

9 A factory or business establishment with more than 100 employees and assets over $500,000 (excluding land) is considered a large business by the Government of Cambodia (Government of Cambodia 2005).

US markets because the Multi Fibre Agreement (MFA), which imposed quota restrictions on textile products and especially textile products from the PRC, was in effect until 2004.[10] Finally, the 1997–1998 Asian financial crisis served as an impetus for the rapid development of the textile industry in Cambodia, which had been less affected by the crisis.

Cambodia captures a relatively limited share of the value chain in the global garment industry. Cambodia is involved in the "cut, make, and trim" phase of the value chain. The Cambodian industry produces only garments, while most of the raw materials, fabrics, and machines are imported from the PRC and other economies in the region. According to the Garment Manufacturers Association of Cambodia, the country's garment industry imported $1 billion in raw materials in 2009, with 66% coming from the PRC and the rest from the Republic of Korea and Taipei,China. According to Cambodian tax law, the import taxes on raw materials serving industries in the country are very low if the final outputs are exported. Because the industry enjoys import tax exemptions as well as tax holidays (Ear 2009: 8), the industry's direct contributions to government revenues have been limited. More than 95% of garment factories are foreign-owned, and a significant part of the profits are repatriated. Nevertheless, this industry is critical for poverty reduction in Cambodia due to its contribution to export-led growth (Yamagata 2006).

Case Study: Company A (Cotton Producer and Exporter)

Company A is a major cotton exporter. The company was founded in 2006 by a Cambodian businessperson with the primary goal of exporting cotton to the PRC. A PRC businessperson visited Battambang Province in Cambodia and suggested to the eventual founders of Company A that they grow cotton for export to the PRC. She offered assurances that she would buy all the cotton produced by the company. The founders of Company A visited the PRC several times to study its local markets and decided to start their business upon returning to Cambodia.

Today, Company A has a total of 80 employees, of whom 40 are regular staff, and investment capital worth over $2 million. It has a cultivated land area of more than 1,500 hectares, up from 100 hectares at its inception, in the Rottanak Mondul district of Battambang Province. The total export volume of Company A reached 150 tons per year in 2009 and the company is one of Cambodia's top cotton exporters. The main export markets include the PRC, Japan, the Republic of Korea, and Viet Nam. Even though the PRC only began importing cotton from this company in February 2010, it has already become the firm's second-largest market at 50 tons per year, trailing only Viet Nam. When asked why the firm only started to export cotton to the PRC in February 2010, the company's management confessed that it tried to avoid relying too much on exporting to the PRC to prevent having low prices dictated by its PRC partner. At the same time, however, the company's management admitted that they rely heavily on their PRC business partner in order to export to the PRC market. Company A does not have information about the end-users of their products, which are factories in the PRC. Instead, the company relies heavily on intermediaries to market its products in the PRC.

Recently, Company A decided to import several modern cotton processing machines from the PRC at the price of $600,000 per unit. Despite the high cost, the company decided to purchase the machines because the import process was straightforward and free from overly

[10] Even after the end of the MFA in 2004, the garment industry in Cambodia was still able to compete in international markets and maintain its dynamism in exporting to Canadian, EU, Japanese, and US markets.

bureaucratic procedures. In addition, the Government of Cambodia reduced the import tariff (customs duty) imposed on these machineries to zero.[11] In this example, Company A has clearly benefited from the ACFTA in terms of reduced input expenses.

When asked whether the firm could compete with products imported from the PRC, Company A's project manager was confident about the quality of his products. The quality of the firm's cotton has been tested in a laboratory in the PRC and the results showed that his products were superior to similar items from other countries, including the PRC, with respect to the cotton's endurance and whiteness. Furthermore, business partners, not only in the PRC, but also in Japan and the Republic of Korea, have praised the quality of Company A's products. Companies in the PRC, Japan, the Republic of Korea, and Viet Nam have promised to purchase all of the cotton that Company A can produce. However, the company's management worries that they may not be able to supply all of these markets in a timely fashion given that cotton requires a much longer period and more land under cultivation to grow than other crops.[12]

In spite of these positive developments, Company A's project manager admitted that there are some problems regarding export procedures. Without disclosing how much he has to pay to get an export permit, he admitted that the permit process requires that unofficial fees be paid to avoid delays.

In addition to this problem faced by Company A on the Cambodian side of the border, the project manager identified another major problem on the PRC side. When the products arrive in the PRC, PRC customs officers there require his business partner, who is in charge of conducting import procedures, to fill in a number of papers in addition to the certificate of origin, a process that usually takes about 1 month. Only after all paperwork has been finished can the products be imported. In contrast, customs officers in Viet Nam do not require many papers (except the certificate of origin), according to the project manager. This is one of the reasons that Company A chooses to export more to Viet Nam than to the PRC.

To cope with these challenges, Company A suggested that the government could help the company by easing its export procedures and customs clearance processes. For instance, the government could charge a fee for phytosanitary inspection only and eliminate the rest of the procedures. In addition, the company's management also requested the Govenment of Cambodia to grant multiple export permits with a certain validity period (e.g., 1 year) so that the firm need not waste resources completing paperwork for each export transaction.

Case Study: Company B (Textile Producer and Exporter)

Company B is a supplier of apparel products. The company produces its apparel in accordance with the design, quality, and quantity requested by buyers from other countries, particularly in Canada and Europe. The trademark and brand names of the products are designed by either the buyers or partner companies. The company was established in 2000 by an entrepreneur from Hong Kong, China. The parent company, which is in charge of finding buyers and partners, was established in Hong Kong, China and its factories are located in Cambodia and the PRC. Company B has established strong business connections with buyers in Europe. The factory in Cambodia has a staff of 400 , 90% of which are female. The company produces jackets and

[11] In addition, other taxes on raw materials imported from the PRC to Cambodia, such as cotton seeds and the accompanying packing materials, were also abolished under the ACFTA scheme.

[12] For instance, at least 260 cotton fruits are used to make 1 kilogram of cotton.

sweaters, all of which are exported to Europe.[13] The production inputs of the company are raw materials imported from the PRC and the labor inputs are sourced from the local Cambodian people. Given that almost all textile producers in Cambodia are only suppliers and they are not involved in the process of selling in the market, Company B is a typical example of an export-oriented firm in the garment industry in Cambodia.

The company tracks preferential trade arrangements provided by other countries and regions to Cambodia, although the company has never been involved in trade negotiations. Europe has been beneficial for Cambodia's textile exporters since it provided special trade treatment for Cambodian products under the Everything-But-Arms Agreement. As a result of this preferential trade treatment, Company B started operating in Cambodia with the intention of exporting to Europe.

When asked about the ACFTA, the company representative said that she was not aware of the agreement and it did not affect Company B's operations because it was already importing raw materials from the PRC on a freight-on-board basis, thereby avoiding import tariffs in accordance with Cambodian investment law and the investment facilitation policy of the Council for the Development of Cambodia.[14] While the company is interested in learning whether there are any enhanced export opportunities with the PRC under the ACFTA, there seems to be a very little opportunity at present, because products from the PRC are very competitive. The Company B case study suggests that the ACFTA may have little impact on Cambodian garment producers, especially those that are export-oriented since their market is primarily Europe and not the PRC, and those that import raw materials from the PRC already enjoy import tariff exemption under the existing trade regime.

Regarding competition in other markets (especially Europe), there is some competition between Cambodian products and those from other countries, including the PRC. However, it is the buyers that draw up the marketing strategies, and Company B is not directly involved in such competitive processes. The administrative and shipping officers of Company B are wary that if the special treatment under the Everything-But-Arms Agreement were ended, there would be an increase in competition with PRC products in European markets. However, the company still believes that Cambodian labor, which is much cheaper than labor in the PRC, will continue to make Cambodian garment products competitive.

Case Study: Company C (Textile Producer)

Company C is a textile manufacturer that is owned by a Cambodian businessperson and has current investment capital of more than $140,000. The company began its operations in 1995. Before starting Company C, the owner opened a business in 1990 as a clothes vendor at Olympic Market, which is the largest clothes wholesaler in the capital Phnom Penh.[15] Realizing that Cambodia did not produce cotton fabrics, she devised a plan to import raw materials, particularly cotton fabrics, from foreign countries and assemble them in Cambodia to produce clothes. Based on cost calculations, she realized that her products would be highly competitive, given the relatively cheap labor in Cambodia and her company's product design, which is

13 The company does not have any plans to expand its sales in ASEAN markets because its products—jackets and sweaters—are not suitable for tropical ASEAN countries.

14 Company B enjoys other tax incentives, including tax holidays, because the company is 100% export-oriented.

15 She later began selling her products at other markets in Phnom Penh including Oruessei Market, Central Market, Deum Kor Market, and Chbar Ampaov Market.

suitable for Cambodian preferences. Her relatives helped her by suggesting where and how to purchase cotton fabrics from Thailand for use in making her own clothes. Her business has grown since 1995. At its peak, between 40 and 50 packages of ready-made clothes were sold daily with a total value of $4,000–$5,000.[16] The number of employees reached 30 in 2006.

However, sales in recent years have dropped drastically, with only a few packages of ready-made clothes sold daily. Sales now average as low as $200–$300 per day. In response, Company C's owner decided to reduce the number of employees to about 10. When asked to give the reason for sharply decreasing sales in recent years, she pointed to the massive inflow of ready-made clothes from the PRC. Huge numbers of PRC products are now sold at Olympic Market and other markets. The ready-made clothes from the PRC are cheaper than her products by $1.00–$2.50 per item, while their quality is about the same.

When asked to give reasons why she could not reduce the price of her clothes to compete with imports from the PRC, the owner identified high input costs resulting from transport fees, the tariff imposed on imported cotton fabrics, and high electricity costs in Phnom Penh. For example, the tariff imposed on cotton fabrics imported from the PRC and Thailand are both 7% of the total price of the materials. The government provides special tax treatment to export-oriented producers, but not to local market-oriented small companies like Company C. Domestic-oriented SMEs are required to pay import taxes for the cotton fabrics. In addition, the fabrics imported from the two countries are subject to a 10% value-added tax.

The loss of competitiveness compared to ready-made clothes from the PRC has led the owner of Company C to seek cheaper inputs by importing cotton fabrics from Indonesia. The owner revealed that the cost of Indonesian fabrics is about $1.00 per yard (including the import tariff), while the cost of Thai fabrics is about $1.50 per yard. However, the company's owner was still uncertain whether her final products would be able to compete with PRC ones even if Indonesian inputs were used. The owner of Company C suggested that the Government of Cambodia should assist garment-producing SMEs by eliminating tariffs imposed on cotton fabrics imported from ASEAN member states.

When asked why she did not import cheap raw materials from the PRC, especially cotton fabrics, Company C's owner confessed that she did not know anyone who could advise her on the PRC's fabric market and export procedures. She has instead decided to import fabrics from Indonesia and Thailand because she has a relative, who used to trade with Indonesian and Thai cotton fabric suppliers in the past, help her make arrangements with the suppliers and facilitate the importing process.

There are several reasons why Company C does not use homemade cotton (e.g., from the Company A plant) to minimize input costs. First, Cambodian cotton plants do not yet have the capacity to produce the end product: cotton fabrics. They focus more on producing semi-processed cotton for export to other countries that are then used to produce cotton fabrics. A second and related reason is that most cotton plants in Cambodia are export-oriented and are inclined to sell their products to international rather than local markets because they want higher prices.

High electricity costs in Cambodia are another driver of high production costs for Company C. For instance, electricity costs in Phnom Penh range from KR610 ($0.14) to KR720 ($0.17) per kilowatt, depending upon the consumption level. The more electricity consumed, the higher the price per kilowatt that users have to pay. While this policy is designed

[16] One package contains 12 pieces of ready-made clothes.

to help minimize electricity consumption, such a pricing mechanism makes the realization of economies of scale difficult.

In conclusion, the case of Company C shows that the ACFTA may have a serious adverse impact on small Cambodian garment producers whose production is mostly based on raw materials imported from ASEAN countries rather than the PRC. With the same treatment for imported ASEAN and PRC products (tariff and value-added tax), ASEAN textile producers that import raw materials from ASEAN countries to produce end products such as clothes may not be able to compete with ready-made clothes from the PRC because of their extremely low prices. This suggests that ASEAN should abolish the tariff imposed on raw materials imported from other members as soon as possible so that the products of small ASEAN textile manufacturers can become more competitive with PRC textile imports.

Summary of Empirical Findings of Garment Industry Case Studies

First, the bottleneck of Cambodia's garment industry is due to the fact that there are no midstream sectors in the whole value chain, while its upstream and downstream sectors are strong. The upstream sector—cotton production—is very competitive even when compared with the PRC, and the majority of production is exported to other countries, mainly European markets. Most of the downstream sectors are also notably export-oriented. Most of them simply produce final products, using imported materials, based on the design and orders from companies and buyers in other countries, particularly in Europe. While the upstream and downstream sectors in Cambodia's garment industry are competitive, the industry as a whole has not exploited business opportunities due to the lack of midstream sectors. In fact, the production of fabrics and textiles in Cambodia is very limited. Naturally, companies in upstream and downstream sectors concentrate on exporting their products, rather than establishing a complete value chain in the country. If efficient midstream sectors existed in Cambodia, then domestic companies would be able to produce clothing and apparel final outputs using fabric and textiles made in the country with Cambodian cotton.

Second, export procedures in Cambodia sometimes constrain the domestic garment industry, although this seems to happen less frequently than in other industries. For example, export procedures are a more urgent problem for the Cambodian food industry, discussed in the next section. If the government were to grant a multiple export permit with a certain validity period, instead of a series of single permits, firms could save time by avoiding tedious paperwork. The PRC's cumbersome import procedures also affect Cambodia's exports to the PRC. Several companies point out that customs in the PRC require several certificates in addition to certificates of origin, which is not the case with Cambodian exports to other neighboring countries, including Viet Nam. Thus, Cambodian companies tend to export to Viet Nam more than to the PRC.

Finally, the impacts of the ACFTA on Cambodia's garment industry, which is generally an export-oriented industry led by a small number of large-scale, foreign-owned companies, are limited. However, the ACFTA has had some adverse effects on domestically oriented SMEs. Large-scale companies, whose products are typically exported, are already enjoying the tariff-free import of their materials under Cambodian investment law. Thus, the ACFTA has no impact on their imports from the PRC. Because large-scale companies' main export markets are in Europe, the ACFTA does not have a substantial impact on their exports either. In contrast, domestically oriented SMEs, whose sales principally target domestic markets, face substantial negative effects from the ACFTA, usually without enjoying any benefits. Under the ACFTA, final apparel products made in the PRC enter the Cambodian market, where there is already fierce competition, tariff-free. Moreover, because their products are sold domestically, SMEs are unable to import raw materials tax-free, unlike large foreign firms. A lack of business partners in the PRC is another reason why some firms import materials from other ASEAN countries instead of the PRC.

Food Industry

The manufacturing industry in Cambodia is still in its infancy, dominated by light industries that employ low technology. However, Cambodia is now pursuing a more export-oriented, rather than an import-substitution, development policy. The garment industry is the top export-oriented manufacturing sector in Cambodia. Other light industries, especially the food industry, are focused on local rather than foreign markets. The food industry in Cambodia has the potential to expand its international sales by utilizing mass production with low input costs and high-quality output.

SMEs, which make up approximately 95% of all enterprises and account for almost half of all employment, are the backbone of the Cambodian economy. The Government of Cambodia has emphasized the important role of SMEs in economic growth and poverty reduction in its Second Socio-Economic Development Plan and National Poverty Reduction Strategy. According to the Cambodian Ministry of Industry, Mines, and Energy, 82% of SMEs in 2006 were in the beverage, food, and tobacco sector (USAID 2006). Given that such a major portion of the workforce is employed in this industry, its development is critical for pro-poor growth in Cambodia (Kobayashi et al. 2009).

The food processing industry in Cambodia is still developing. It is facing several constraints and weaknesses, including the lack of processing facilities, food processing technology and skills, market analysis and marketing information, and sanitation and hygiene knowledge; as well as poor infrastructure, an unreliable supply of raw materials, and the low levels of competitiveness among its products due to high operating costs (COSECAM and Plan Cambodia 2009: 23).

Case Study: Company D (Rice Producer and Exporter)

Company D operates various businesses within the rice industry, including milling, purchasing, and exporting. Company D was founded by a Cambodian businessperson in 1993 with an initial investment of slightly more than $10,000. Today, it has become one of the country's main rice producers and exporters, employing 80 people and with investment capital of approximately $2 million. Only six staff members earn a regular annual salary, while the rest are paid a daily allowance of about $3 per day. The firm has the capacity to produce 110 tons of rice per day to meet local and overseas demand, which is a significant increase from only 8 tons per day during its initial years. Company D exports about 3,000 tons of rice each year, accounting for 0.6% of total Cambodian rice exports.

The company exports rice to foreign markets such as France; Hong Kong, China; Italy; Portugal; Switzerland; and the US. The company's founder is not worried about competing with products from the PRC in international markets, as he strongly believes in the quality and relatively low price of his rice. When asked why the company has not exported to the

PRC, the respondent confessed that he had always wanted to do so, but he had yet to establish a connection with any intermediary who could introduce his company to clients in the PRC. For this reason, Company D plans to dispatch a market study team to the PRC in the near future to conduct a feasibility study and, if possible, establish trade ties with a rice-importing firm.

Even though Company D had little knowledge of opportunities available through the ACFTA, the firm has already benefited from the ACFTA to a certain extent. The respondent said that the company's rice productivity has dramatically increased in recent years due to the application of more advanced technologies in the production process. These technologies, particularly rice color sorting machines, are imported from the PRC. The general director of Company D decided to purchase these machines from a local supplier because their quality is similar to those of machines imported from Japan and Thailand, while the cost is much less. Rice color sorting machines made in the PRC cost about $30,000 per unit in Phnom Penh compared with similar machines imported from Japan and Thailand that cost approximately $60,000 per unit. Import tariffs on agricultural machines from the PRC were reduced to zero in May 2008, creating favorable conditions for the rice milling industry to raise its competitiveness in both local and international markets.

The firm still faces complicated export procedures that cause delays in delivering products to its foreign clients. To encourage exports to foreign countries, such as the PRC, the company strongly seeks the easing of the Government of Cambodia's export procedures, which are the source of two main problems. First, the delivery process of products is regularly delayed as companies spend too much time clearing export applications through the two main government ministries: the Ministry of Commerce and the Ministry of Agriculture, Forestry, and Fisheries. It takes at least 5–7 days to finish the paperwork before a firm can proceed with exporting. Second, the time and costs of export logistics lead to increases in the total costs of products, and this leads to significant increases in prices that lower the amount of revenue generated from exports. For example, Company D has to go through at least 15 checking processes and is required to pay for each process, including unofficial solicitation fees, before being able to export its products, resulting in higher expenses. The company has to spend more than $1,000 for each container filled with 20 tons of rice (about $55 per ton) for transport and delivery from Phnom Penh to Sihanoukville, including the export paperwork. Rice exporters from Viet Nam spend approximately $500 for a container of the same size for intra-Viet Nam transport costs, according to Company D's general director.

While Company D still uses the Cambodian port of Sihanoukville because it generates revenue for the government, some exporting firms have decided to export products through Viet Nam's international seaport rather than Cambodia's, because of costly and time-consuming export procedures associated with the Cambodian port. Truck-loading containers are used to transport products from Cambodia, specifically Phnom Penh, across the Cambodia–Viet Nam border (Bavet) to Saigon Port in Ho Chi Minh City. This transport route is considered by some firms to be faster and less costly than the route from Phnom Penh to Sihanoukville. The documents required for products to be exported or transited to Viet Nam are bills of product and packaging invoices, and, in some cases, certificates of rules of origin and phytosanitary documents. While the required documents are almost the same in both countries, transiting through Viet Nam may be less time-consuming and less costly because of its geographical proximity, better infrastructure connectivity, and faster customs procedures. Company D's general director anticipates that more Cambodian exporting firms will begin to use Vietnamese ports as their transit point rather than Sihanoukville unless the government pursues reforms.

On the policy side, Company D's general director suggested that the government should help Cambodian rice-exporting firms that are able to compete with the foreign firms, especially PRC firms, in four ways. First, the government can help ease export procedures by following the suggestions offered earlier. Second, it should provide loans to exporters to help them expand their business. (In order for Company D to expand business recently, it had to borrow money from a private bank at a 10% rate of interest per year.) Third, it should provide more training on new scientific agricultural production methods to Cambodian rice producers to enable them to raise their productivity. Finally, it should grant exporters multiple export permits so that they can deliver their products to foreign countries faster and reduce expenses.[17]

Case Study: Company E (Rice Exporter)

Company E is a rice trading firm. The company was established in 2008 to promote Cambodian rice exports to the region and the world. The company has four managing staff members and very limited investment capital.[18] Although it is a new trading company, it has already established networks with domestic suppliers and overseas clients. Company E conducts transactions with more than 15 milling factories in several provinces in the country. These millers supply high-quality rice to the company based on the standards set by overseas clients.

The company has its own in-house export facilitation services and notes that the export process is time-consuming and costly. According to the secretary general of the company, complicated bureaucracy and under-the-table exchanges are the main obstacles to efficient exporting. Another issue is the lack of logistics services and the inefficient transport infrastructure. For instance, the 20-foot containers used to transport rice can be loaded with only 24 tons of rice; whereas those from Viet Nam can be loaded with 25 tons of rice. In addition, the road from Phnom Penh to Sihanoukville is very narrow and in poor condition.

The principal export market of Company E is the EU. The quantity of rice exported to the EU has been increasing over the last few years. While the company exported about 70 tons per order in the past, it now exports up to 1,500 tons per order. Such a positive upward trend explains the attractiveness of the EU market for Cambodian rice exporters. According to the company, under the Everything But Arms Agreement between Cambodia and the EU, Cambodia is now able to export rice products to the EU tariff free. The absence of tariffs increases the competitiveness of Cambodian rice in the EU market. The company so far has not had any problem regarding the quality standards demanded by buyers from EU countries.[19] When asked why the company does not export rice to Japan or the US, the secretary general explained that Japan and the US are potentially attractive markets, but the company does not have business connections nor has it identified demand in either of these two countries.

According to the secretary general, the PRC's import procedures are complicated since it sometimes does not recognize certificates of origin from Cambodia. Asked why the PRC

[17] Export firms receive a single permit each time they export. If they want to export again, they have to apply for another permit.

[18] The company borrows from the bank based on actual orders from foreign clients. As such, the company needs little working capital.

[19] The company refused to buy rice that was produced with genetically modified organisms. This is due to restrictions set forth by the EU, which does not accept this type of rice.

does not accept certain certificates of origin from Cambodia, the secretary general shared his personal view that PRC authorities probably did not fully trust the documents issued by the Cambodian authorities, despite their obligation to recognize them under both the World Trade Organization and ACFTA frameworks.[20] Based on its business experiences in the PRC, the company also notes that when rice arrives at ports in the PRC, the process of unloading normally takes up to 7 days. Asked further about their knowledge of the PRC market and the ACFTA, the secretary general replied that there was little knowledge about the agreement and he was not aware of the tariff benefits that apply to rice products under the ACFTA. At this stage, complicated trade procedures and a lack of market information on the PRC make Company E more dependent on traditional markets, such as the EU, for export. The company exported to the PRC only once in 2009 and found it difficult due to complicated import procedures.

Case Study: Company F (Food Producer)

Company F was established in 2002 by a young Cambodian businessperson with the goal of providing jobs to Cambodians, creating a market for local products such as corn and rice, and substituting domestic food products for imported foreign products. Company F has grown quite remarkably since its inception. In 2002, it had only 25 workers and investment capital of about $100,000. In 2010, the company employed more than 100 regular staff members and had a working capital of about $1 million. The company focuses exclusively on the domestic market, with children as its primary market. Since the company's domestic market share is still small, it is looking for international partners to introduce new technology that will lead to a mass production system. The company's net profits are approximately 10% of total sales, and the profit is used mainly for reinvestment and business expansion. The company's vision is to help Cambodian farmers gain market access and to provide employment opportunities to the Cambodian people.

The production cost structure of the company is 40% for packaging, 30% for labor (domestic labor force only), and 30% for other costs (e.g., electricity and water). The reason that packaging is the most costly component because the company needs to import plastic bags from neighboring countries, mainly Viet Nam, because the packaging industry in Cambodia is not competitive due to high costs and the low quality of its products. (High electricity costs also reduce the competitiveness of Cambodian products.) As a result, overall production costs for Company F in Cambodia are higher than they are for firms in Thailand or Viet Nam.

The lack of sophisticated production technology limits the production capacity of the company. The machinery used for production is secondhand and not very efficient. The company spends a lot of money maintaining and repairing its machines. The owner and manager are looking for partnerships or joint ventures with foreign investors to introduce a mass production system and lower the unit cost of production. Without such a technological upgrade, the company is at risk of losing its competitiveness compared to imported food products from the PRC, Thailand, and Viet Nam.

The company has not yet exported any of its products, but management wants to begin exporting products to neighboring countries. However, the complicated export process and lack of capacity (especially in terms of capital and production technology) constrain the

[20] Article 5 of the agreement on trade in goods between ASEAN and the PRC states that "the rules of origin and the operational certification procedures applicable to the products covered under this agreement and the early harvest program of the Framework Agreement are set out in Annex 3 of this agreement."

company from doing so. Asked about her awareness of the ACFTA, the owner expressed a lack of knowledge on regional trade arrangements. Although the government regularly invites her to attend various workshops and meetings, most of these focus on the development of SMEs producing for domestic markets, not SMEs that export to foreign markets. She urged the government and international institutions to further assist the private sector, especially SMEs, in exporting to regional markets and joining regional production networks. In addition, the company expressed the view that the government can assist SME brand promotion in foreign markets, given that it is nearly impossible for SMEs to promote their brands in export markets on their own due to financial constraints.

On the question of whether the company is facing competition with similar products imported from the PRC, the company's owner and manager mentioned that they did have competition in imported food products—especially from the PRC, Thailand, and Viet Nam—but the company is able compete with imported products through quality, cost, and marketing strategies. The manager is confident that Company F can expand its market share in Cambodia.

Case Study: Company G (Palm-Related Food Producer and Exporter)

Company G was registered in 2001. Before the establishment of the company, the owner, a Cambodian–French national, studied products that can be produced from palm juice with the aim of assisting Cambodian farmers. The owner brought palm juice from Cambodia to France for laboratory research. He learned that wine, organic sugar, and vinegar can be made from palm juice. The owner then decided to invest in building a small factory outside of Phnom Penh to produce products from palm juice. The products of the company include organic palm sugar, organic vinegar, palm drink, and different types of wine and whiskey. The factory can produce 60,000 bottles of wine and whiskey per year, 12 tons of organic palm sugar per year, and 100,000 liters of vinegar per year.

For palm wine and whiskey, the company's main focus is domestic markets, with only about 1% of its total production exported to France. Export to France is usually through unofficial channels such as tourists, friends, and acquaintances. Wine and whiskey bottles are imported from France, at a cost of about $1 per bottle. The cost of bottles is high partly because the company orders only a small number each time. Some types of palm wine cost only $2, which means that the bottle's cost is already half of the total price. However, the company prefers to import wine and whiskey bottles from France because of their superior design and quality. Such high costs make the company less competitive in international markets, and moreover, less competitive against imported products in the domestic market.

For organic palm sugar, the main target is international markets. The company now exports organic palm sugar to France; Japan; Singapore; Taipei,China; and the US. The French market is the company's largest. Exports overseas are usually managed through business partnerships with buyers and intermediaries from the destination countries. The critical bottlenecks to sugar exports are transport costs and customs procedures. The company pointed out the high transport and customs clearance costs in Cambodia. Company G uses transport services from its factory near Phnom Penh to the port in Sihanoukville, supplied by outside service providers, at a cost of $1,700–$2,000 per container of organic palm sugar. Packaging costs are also high. About 50% of the total cost of each unit produced is spent on packaging. The company orders plastic boxes from Viet Nam and packs its products in Cambodia. The company finds it difficult to export because of high transport fees and customs clearance costs in Cambodia.

For vinegar, the main market is domestic. The company cannot export vinegar products due to the lack of certificates of standard—such as the Good Manufacturing Practice, International Organization for Standardization, and Applied Science Accreditation Commission—that buyers demand. These standard quality certificates are technical standards that are necessary for the company to export their beverage products to international markets. To certify the quality of its products, Company G started conducting several checks—a visual and tactile check (shape, taste, and texture)—at every stage of the production process, using the latest technology. Through a partnership agreement with the French Agricultural Research Centre for International Development, training and technical support are being provided to the manufacturing engineers of the company. Obtaining the accreditation certificates listed above is very costly for a small local producer such as Company G. It may take time for the company to expand its production capacity and enlarge its operations, and only then can the company consider applying for these certificates to export.

Company G is interested in expanding its international sales, especially in the PRC. At the moment, however, the company finds it difficult to enter the PRC market due to a lack of price competitiveness compared to PRC products. The manager was not aware of the involvement of the private sector in regional trade negotiations and information on regional trade agreements, particularly the ACFTA. The company conducts trade based on business-to-business relationships, with little consultation with (and even less support from) the government. The manager showed interest in exporting the company's products to the PRC under the ACFTA if it could be demonstrated to easily bring preferential market access. The company is also interested in the ASEAN market and will seek to expand its market access to the PRC and ASEAN through improved quality and production capacity.

Summary of Empirical Findings of Food Industry Case Studies

First, the largest bottleneck in Cambodia's food industry, in terms of reducing competitiveness in international markets, is the lack of supporting industries. Food, particularly low-value-added food, is generally competitive internationally (e.g., Cambodian rice), but the productivity of Cambodia's processed or value-added food is low because of high costs associated with the packaging process. Because Cambodia does not produce high-quality packaging, the Cambodian food industry needs to import packaging materials from neighboring countries such as Viet Nam. In the case of palm wine, which is popular in the EU market, half of the total production cost is spent on bottles imported from France, since without well-designed bottles it is difficult to sell internationally. Thus, in order for Cambodia's food industry to become profitable enough to successfully export, the establishment of supporting industries is urgently needed.

Second, given the nature of food products, export and import procedures are a more sensitive concern than they are for garment-related products. Sanitary issues are critical for food products, and lengthy customs and other procedures significantly affect the quality of some food products. Under-the-table fees are also a major deterrent because they not only increase costs, but also delay the export process. Many firms pointed out that a multiple export permit is necessary to reduce the time and financial costs of trade, and, more importantly, to possibly contribute to a reduction in unofficial fees. A lack of high-quality transport infrastructure is another issue. Because of these problems, some Cambodian firms export products through Viet Nam to final destinations, rather than directly from Sihanoukville.

Third, the impact of the ACFTA on Cambodia's food industry seems to be limited. Above all, Cambodian food producers and traders realize that PRC products are competitive within Cambodian markets, yet it is not easy for Cambodian exporters to penetrate the PRC's markets, with the notable exception of rice. While some firms are interested in exporting to the PRC in the future, limited knowledge of the PRC's markets and the ACFTA, and a lack of business partners and marketing strategies are the main challenges. As a result, the major export market for Cambodian food products has been the EU, and this situation seems likely to continue. Meanwhile, tariff-free imports of high-quality but inexpensive machines under the ACFTA, such as rice millers from the PRC, contribute to higher levels of productivity throughout the Cambodian food industry.

Fourth, although it is true that the PRC cuts tariffs on food imports from Cambodia under the ACFTA, the PRC's import procedures are sometimes a major obstacle for Cambodian exporters to overcome, especially with respect to food products. The certificates of origin issued by Cambodian authorities are sometimes not fully recognized by PRC authorities, and products from Cambodia therefore do not always enjoy preferential status in the PRC's markets. Partly due to complicated procedures required by the PRC authorities, some Cambodian firms either avoid or have given up exporting to the PRC.

Policy Considerations

The ACFTA has created major business opportunities for Cambodian industries. At the macro level, Cambodia's trade with the PRC has been increasing very rapidly in recent years. In 2010, Cambodia's exports to the PRC more than doubled from the previous year (footnote 1). Such a macro view is consistent with the export policies of companies analyzed in this paper, some of which have already exported to the PRC, or at least plan to export their products to the PRC's markets.

At the same time, the ACFTA also presents challenges for key Cambodian industries, including garments and food. The benefits gained are limited to increased market access opportunities for some Cambodian products, and for producers who import raw materials and production machines from the PRC. Moreover, the impact of the ACFTA varies across industries in terms of manner and magnitude. In general, Cambodia still finds it difficult to take advantage of the ACFTA due to a lack of technology, investment capital, and human resources, and the nonavailability of local suppliers of production materials.

The final section considers necessary policy actions to exploit the export opportunities brought about by the ACFTA and regional trade agreements in general. Six suggestions can be extrapolated from the detailed analysis in the previous sections. The recommendations are classified into two groups. The first four recommendations are general in scope, with exports to the PRC expected to increase significantly if these recommendations are implemented properly. If the status quo persists, however, exports to the PRC are unlikely to increase significantly because of a range of constraints that Cambodian industries face. The final two recommendations are related to policies toward the ACFTA and the steps necessary to maximize the potential benefits of this agreement.

Recommendation 1: Simplify trade procedures and eradicate unofficial fees. All export industries in Cambodia are faced with sophisticated, costly, and time-consuming export procedures, as well as high logistics and transport costs. The government needs to reduce bureaucratic constraints in the export process to encourage the private sector to fully harness its export potential. In addition, the government should establish a single-window service for all procedures related to the export process. All of the firms interviewed raised concerns about the high unofficial facilitation fees required to export their products. The government needs to deal with this issue seriously by enforcing the newly adopted anticorruption law, setting up an effective monitoring mechanism, and improving law enforcement. The private sector, especially exporting firms, should be given direct access to senior leaders of the relevant anticorruption units. Only through partnership and cooperation between the public and private sectors can these unofficial fees be reduced. It should be noted that burdensome export procedures and corruption are interrelated. Some officials prefer single export permits over multiple export permits because they can collect unofficial fees more frequently. Thus, simplifying trade procedure is an effective way to reduce corruption.

Recommendation 2: Develop hard infrastructure and logistics services. Hard infrastructure (particularly road and railway) connectivity needs to be improved. Public institutions and development partners need to strategically identify and develop hard infrastructure to facilitate increased exports. Exporters tend to use Vietnamese ports instead of Sihanoukville because the related transport costs are cheaper and the process less time-consuming. In addition, the private sector should invest more in logistics services, while the deregulation of investments in the transport sector is strongly encouraged.

Recommendation 3: Develop human resources development and build capacity for exporting firms. Underdeveloped human resources are the main constraint facing exporting firms. In the food industry, human resources are extremely limited, especially in the field of production engineering and management science, which are critical to reducing costs and guaranteeing international quality standards. Personnel are needed in agricultural engineering and laboratory and scientific research to increase crop productivity and develop the agro-industry in a sustainable way, given that Cambodian agricultural products still have very low value-added. Development partners should implement more projects to support the productivity of agricultural exporting firms in Cambodia. Capacity-building projects within the private sector should be encouraged and further developed.

Recommendation 4: Establish local suppliers, supporting industries, and a value chain. The garment industry in Cambodia faces a serious lack of local suppliers, such as fabrics producers. While some sectors in the industry are competitive, the industry as a whole is not competitive, because only a part of the value chain exists in Cambodia. Value chain creation within the production network is necessary for job and income generation. In relation to this, it is important to build up supporting industries. For example, Cambodia's food industry has not been competitive enough because firms need to use expensive imported packaging materials. It is not the process of food production itself, but rather the need to import packaging materials, that pushes up the cost of Cambodian food products. If inexpensive, high-quality packages were produced in Cambodia, the Cambodian food industry could become more competitive and profitable. Thus, the government and development partners should support the establishment of local suppliers and other supporting industries.

Recommendation 5: Improve information dissemination on international markets and free trade agreements. The government and development partners need to provide more information on regional trade agreements and offer support to the private sector in designing appropriate market entry strategies. Information on the benefits of using FTAs to enjoy preferential export treatment should be widely disseminated among Cambodian exporters, including SMEs. Rigorous market research on international markets for Cambodian exporters is also necessary. In many cases, Cambodian firms face difficulty in exporting to other countries, including the PRC, simply because of a lack of market information. Weak commercial networks, especially international networks, are another critical problem. Instead of directly exporting to the PRC, Cambodian firms sometimes need to export to intermediaries in other countries who have commercial connections with the PRC. In addition, the private sector should be encouraged to participate more in regional trade agreement dialogues to enable them to raise their concerns.

Recommendation 6: Improve the quality of Cambodian products through upgraded technology. The food industry in Cambodia lacks international quality standards. Public institutions and development partners to help the private sector, especially exporting firms and factories, to improve the quality of their products. Technology transfer also contributes significantly to improving the quality of their products and their production capacity. Foreign direct investment and foreign–local business partnerships will encourage increased technology and knowledge transfer, which can contribute significantly to the development of infant industries in Cambodia. The import of machinery with the latest technology is also very important. Some subsectors of the agriculture sector, such as cotton production, have been enjoying tariff-free imports of machinery from the PRC under the ACFTA, resulting in increased productivity. Reducing tariffs on machinery other than agricultural machinery under the ACFTA framework would contribute to higher productivity among Cambodian industries.

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Appendix: Questionnaire for the Project—The Impacts of Regional Trade Arrangements on Cambodian Industries[21]

Background of the Company

- Name of respondent
- Name of firm
- Type of products
- Number of regular employees
- Year of firm establishment
- Type of firm: 1. Fully owned multinational. 2. Fully owned domestic firm. 3. Fully owned foreign firm. 4. Foreign–domestic joint venture firm

Questions

- Do you know about Cambodia's free trade agreements with other countries and regions? (A. Yes or B. No) If you choose A, please specify the types of agreement.
- Do you know about the Association of Southeast Asian Nations (ASEAN)–People's Republic of China (PRC) Free Trade Agreement, also referred to as the ACFTA? (A. Yes or B. No)
- Do you think that the Government of Cambodia has widely disseminated the ACFTA to the private sector? (A. Yes or B. No or C. Do not know)
- Has your company been involved with any free trade negotiations so far? (A. Yes or B. No or C. Do not know) If you choose A, please specify number of times your company has been involved.
- Has there been any structural change within your company in recent years, such as revenues, market, and production network? (A. Yes or B. No) If you choose A, please specify what kinds of changes has your company made.
- Who are your suppliers? From which countries or regions do they originate?
- Who are your main customers? Do you export your products to the PRC?
- Do you have any plans to export to ASEAN and the PRC? How will you do this?
- What are the sources of your company's raw materials? Do you have any difficulty importing those materials?
- Which countries does your company import technologies and machines from? Do you have any difficulty in importing these technologies and machines?
- Do you have any plans to form joint ventures with foreign firms?
- Have the import, export, and production processes of your company as a whole improved recently? What kinds of problems has your company faced with the above processes?
- What are the main constraints of your company in exporting the products or services to other countries in the region, especially the PRC?
- Could your products and/or services compete with PRC products in the Cambodian market? Why?

[21] The format is changed from the original.

- What are you going to do to increase your company's competitiveness against PRC products or services?
- What kinds of help do you need from the Government of Cambodia in order to boost your company's competitiveness against products and/or services from foreign countries, especially the PRC?